CAPTARIS INC
Form 10-Q
November 03, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2006

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________.

Commission File Number 0-25186

CAPTARIS, INC.

(Name of Registrant as Specified in Its Charter)

Washington	**91-1190085**
(State of Incorporation)	**(I.R.S. Employer Identification Number)**
10885 N.E. 4th Street, Suite 400	
Bellevue, WA	**98004**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s telephone number, including area code: (425) 455-6000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes **x** No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of outstanding shares of the registrant s common stock as of November 1, 2006 was 27,034,419.

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FORM 10-Q

For the Quarter Ended September 30, 2006

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CAPTARIS, INC.

Forward-Looking Statements

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, intend, anticipate, believe, estimate, predict, potential, continue, could, future, s these terms or other terminology. These statements are only predictions. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors that may cause our actual results to differ materially from any forward-looking statements. Factors that could affect Captaris actual results include, without limitation:

Quarterly and seasonal fluctuations in operating results, which may negatively impact the trading price of our common stock.

Our inability to compete successfully against current and future competitors.

Our inability to meet technology and customer demands in a rapidly changing industry.

Our inability to integrate recent and future acquisitions.

Our inability to obtain fax processing circuit boards, a key component of our RightFax product, on acceptable terms, which may be affected by significant changes in technology, issues regarding quality performance, delays, interruptions or reductions in our supply, or unfavorable changes to price and delivery terms.

Our inability to maintain or expand our network of resellers, distributors and IT service providers.

Our inability to establish and maintain OEM and strategic relationships.

Our inability to maintain and expand our international operations, which are subject to numerous risks, including, difficulty in adapting products to local languages and technologies, regulatory requirements, exchange rate fluctuations, restrictive governmental actions, import/export licensing requirements, limits on the repatriation of funds, longer receivables cycles, staffing/managing international operations, adverse tax consequences and changing local and international environments.

Our inability to affect and forestall potential declines in the average sales prices on our products, which could cause our overall gross margins to decline.

Our inability to protect our proprietary rights or to operate without infringing the patents and proprietary rights of others.

Ongoing litigation matters and disputes, including litigation related to the Telephone Consumer Protection Act (as further described under Legal Proceedings in this report).

Our inability to protect against security breaches and exposure of confidential data, which if breached could subject us to litigation, liability and decreased market acceptance of our products.

Our inability to attract and retain qualified employees.

More information about factors that potentially could affect Captaris financial results is included under Item 1A Risk Factors in our most recent Annual Report on Form 10-K and in other Quarterly Reports on Form 10-Q filed by us with the Securities and Exchange Commission in fiscal year 2006. Readers are cautioned not to place undue reliance upon these forward-looking statements that speak only as to the date of this report. Except as required by law, Captaris undertakes no obligation to update any forward-looking or other statements in this report whether as a result of new information, future events or otherwise.

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PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

CAPTARIS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

(unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,578	$ 6,420
Short-term investments, available-for-sale	13,191	17,506
Accounts receivable, less allowances of $1,402 and $1,369	15,920	18,776
Inventories	796	534
Prepaid expenses and other	2,724	1,759
Deferred tax assets and income tax receivable	2,229	4,141
Total current assets	43,438	49,136
Long-term investments, available-for-sale	35,108	27,601
Restricted cash	1,000	1,000
Long-term assets	297	337
Equipment and leasehold improvements, net	4,308	6,200
Intangible assets, net	7,263	9,767
Goodwill	32,741	32,313
Deferred tax assets, net	4,366	4,849
Total assets	$ 128,521	$ 131,203
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,896	$ 4,665
Accrued compensation and benefits	3,829	3,764
Other accrued liabilities	1,966	2,390
Income taxes payable	165	80
Deferred revenue	19,003	18,104
Total current liabilities	28,859	29,003
Accrued liabilities noncurrent	315	317
Deferred revenue noncurrent	4,791	4,104
Total liabilities	33,965	33,424
Commitments and contingencies (Note 5)		
Shareholders equity:		

Preferred stock, par value $0.01 per share, 2,000 shares authorized; none issued and outstanding		
Common stock, par value $0.01 per share, 120,000 shares authorized; 27,205 and 28,367 outstanding, respectively	272	284
Additional paid-in capital	45,090	50,835
Retained earnings	47,545	45,809
Accumulated other comprehensive income	1,649	851
Total shareholders equity	94,556	97,779
Total liabilities and shareholders equity	$ 128,521	$ 131,203

See the accompanying notes to unaudited condensed consolidated financial statements.

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CAPTARIS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Quarter Ended September 30, 2006	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net revenue:				
Software revenue	$ 9,647	$ 8,331	$ 25,164	$ 23,169
Maintenance, support and services revenue	9,385	8,192	26,693	23,408
Hardware revenue	5,528	5,232	14,906	15,140
Net revenue	24,560	21,755	66,763	61,717
Cost of revenue	7,441	6,608	19,855	19,650
Gross profit	17,119	15,147	46,908	42,067
Operating expenses:				
Research and development	3,029	3,476	9,387	10,228
Selling and marketing	7,806	8,830	23,779	25,206
General and administrative	3,929	4,623	12,139	14,091
Amortization of intangible assets	354	454	1,062	1,362
Gain on sale of discontinued product line CallXpress (Note 7)			(1,000)	(1,000)
Total operating expenses	15,118	17,383	45,367	49,887
Operating income (loss)	2,001	(2,236)	1,541	(7,820)
Other income (expense):				
Interest	481	281	1,394	835
Other, net	(146)	(82)	(237)	(210)
Other income, net	335	199	1,157	625
Income (loss) from continuing operations before income tax expense (benefit)	2,336	(2,037)	2,698	(7,195)
Income tax expense (benefit)	693	(1,343)	989	(3,137)
Income (loss) from continuing operations	1,643	(694)	1,709	(4,058)
Discontinued operations:				
Gain (loss) on sale of MediaTel assets, net of income tax expense (benefit) of ($11), $3, $17 and $23, respectively	(16)	5	27	35
Income (loss) from discontinued operations	(16)	5	27	35
Net income (loss)	$ 1,627	$ (689)	$ 1,736	$ (4,023)
Basic net income (loss) per common share:				
Income (loss) from continuing operations	$ 0.06	$ (0.02)	$ 0.06	$ (0.14)
Income (loss) from discontinued operations	(0.00)	0.00	0.00	0.00
Net income (loss)	$ 0.06	$ (0.02)	$ 0.06	$ (0.14)
Diluted net income (loss) per common share:				

Income (loss) from continuing operations	$ 0.06	$ (0.02)	$ 0.06	$ (0.14)
Income (loss) from discontinued operations	(0.00)	0.00	0.00	0.00
Net income (loss)	$ 0.06	$ (0.02)	$ 0.06	$ (0.14)
Weighted average basic common shares	27,859	29,056	28,131	29,077
Weighted average diluted common shares	28,472	29.056	28,617	29,077

See the accompanying notes to unaudited condensed consolidated financial statements.

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CAPTARIS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30, 2006	2005
Cash flows from operating activities:		
Net income (loss)	$ 1,736	$ (4,023)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	2,407	2,607
Amortization	2,505	2,806
Stock-based compensation expense (benefit)	476	(239)
Provision for doubtful accounts	113	438
Loss (gain) on disposition of equipment	55	(19)
Changes in assets and liabilities:		
Accounts receivable	3,046	1,238
Inventories	(187)	245
Prepaid expenses and other assets	(916)	(551)
Deferred income tax assets, net and taxes receivable	3,070	(2,693)
Accounts payable	(802)	(2,211)
Accrued compensation and benefits	70	(194)
Other accrued liabilities	(466)	673
Income taxes payable and deferred tax liabilities	(647)	(23)
Deferred revenue	1,586	1,772
Net cash provided by (used in) operating activities	12,046	(174)
Cash flows from investing activities:		
Purchase of equipment and leasehold improvements	(530)	(2,646)
Purchase of investments	(51,965)	(44,002)
Purchase of businesses, net of cash acquired		2
Proceeds from disposals of fixed assets	7	25
Proceeds from sales and maturities of investments	48,878	48,446
Net cash provided by (used in) investing activities	(3,610)	1,825
Cash flows from financing activities:		
Proceeds from exercise of common stock options	1,250	362
Repurchase of common stock	(7,754)	(4,442)
Excess tax benefits from stock-based compensation	271	
Net cash used in financing activities	(6,233)	(4,080)
Net increase (decrease) in cash	2,203	(2,429)
Effect of exchange rate changes on cash	(45)	20
Cash and cash equivalents at beginning of period	6,420	7,563
Cash and cash equivalents at end of period	$ 8,578	$ 5,154

Supplemental disclosures:

Cash paid during the period for income taxes	$	129	$	335

See the accompanying notes to unaudited condensed consolidated financial statements.

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CAPTARIS, INC.

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(in thousands, except share data)

(unaudited)

	Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total Shareholders Equity	Total Comprehensive Income
Balance at December 31, 2005	28,366,988	$ 284	$ 50,835	$ 851	$ 45,809	$ 97,779	$
Exercise of common stock options	387,054	4	1,246			1,250	
Repurchase of common stock	(1,549,506)	(16)	(7,738)			(7,754)	
Stock-based compensation expense			476			476	
Tax benefit from stock-based compensation			271			271	
Unrealized gain on investments, net of income tax expense of $49				105		105	105
Foreign currency translation adjustment				693		693	693
Net income					1,736	1,736	1,736
Balance at September 30, 2006	27,204,536	$ 272	$ 45,090	$ 1,649	$ 47,545	$ 94,556	$ 2,534

See the accompanying notes to unaudited condensed consolidated financial statements.

CAPTARIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Description of the Business and Summary of Significant Accounting Policies

The Business

We develop software products that automate business processes, manage documents electronically and provide efficient information delivery. Our product suite of Captaris RightFax, Captaris Workflow and Captaris Alchemy Document Management is distributed through a global network of leading technology partners. Our customers use our products to reduce costs, comply with regulations and increase the performance of critical business processes and system investments. We operate under one business unit segment to deliver our software solutions.

Basis of Presentation and Preparation

The accompanying unaudited condensed consolidated financial statements as of September 30, 2006, and December 31, 2005, and for the quarter and nine months ended September 30, 2006 and 2005, have been prepared in accordance with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted for interim financial information in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. These unaudited condensed consolidated financial statements should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of management, these condensed consolidated financial statements reflect all adjustments, consisting of normal and recurring adjustments and accruals, necessary for a fair presentation of our financial condition, results of operations and cash flows for the periods indicated.

Principles of Consolidation

The consolidated financial statements include the accounts of Captaris, Inc. and our wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Reclassifications

Certain prior-period balances have been reclassified to conform to the current period presentation. These reclassifications had no impact on revenue, net income (loss), assets or liabilities in either period presented.

Use of Estimates

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements and the reported amounts of revenue and expenses during the reporting period. We base our estimates on historical experience, current conditions and various other assumptions we believe to be reasonable under the circumstances. Our estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources, as well as identifying and assessing appropriate accrual and disclosure treatment with respect to commitments and contingencies. Actual results may differ significantly from these estimates. To the extent that there are material differences between these estimates and actual results, our presentation of our financial condition or results of operations may be affected.

Revenue Recognition

Our revenue recognition policies follow the guidelines of the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable and collection is reasonably assured.

We sell products through resellers, original equipment manufacturers (OEM s) and other channel partners, as well as directly to end-users. Generally our resellers do not stock product, and except for OEM sales described below, we recognize product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. All software licenses are bundled with 30 days of telephone support. We consider revenue associated with this telephone support to be insignificant; therefore, we recognize this revenue when the software is shipped and record an estimate for the related cost of the telephone support. Revenue from term software licenses is recognized over the term of the

CAPTARIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS continued

(unaudited)

license, generally twelve months. Whenever a software license, hardware, installation and post-contract customer support or PCS elements are sold together, we allocate the total arrangement fee among each element based on its respective fair value, which is the price charged when that element is sold separately. The amount of revenue assigned to each element is impacted by our judgment as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. Changes to the elements in an arrangement and our ability to establish VSOE for those elements could affect the timing of revenue recognition for these items. Revenue for PCS is recognized on a straight-line basis over the service contract term, ranging from one to five years. PCS includes rights to unspecified upgrades and updates, when and if available, and bug fixes. Installation revenue is recognized when the product has been installed at the customer s site and accepted by the customer. Recognition of revenue from software sold with installation services is recognized either when the software is shipped or when the installation services are completed, depending on our agreement with the customer and whether the installation services are integral to the functionality of the software. Revenue from perpetual software licenses is recognized when the software has been shipped, provided that collection for such revenue is deemed probable. For software sold to resellers in which we have granted exchange rights, we defer the revenue until the reseller sells the software through to end-users.

We have entered into agreements with certain OEMs from which we receive royalty payments periodically. Under the terms of the OEM license agreements, each OEM will qualify our software on their hardware and software configurations. Once the software has been qualified, the OEM will begin to ship products and report net sales to us. Most OEMs pay a license fee based on the number of copies of licensed software included in the products sold to their customers. These OEMs pay fees on a per-unit basis and we record associated revenue when we receive notification of the OEMs sales of the licensed software to an end-user. The terms of the license agreements generally require the OEMs to notify us of sales of our products within 30 to 45 days after the end of the month or quarter in which the sales occur. As a result, we recognize the revenue in the month or quarter following the sales of the product to these OEMs customers.

We reduce revenue recognized for estimated product returns, based on our historical experience, at the time the related revenue is recorded. If we cannot reasonably estimate returns we defer the revenue until the return rights lapse. When customer acceptance provisions are present and we cannot reasonably estimate returns, we recognize revenue upon the earlier of customer acceptance or expiration of the acceptance period.

Consulting services are customarily billed at fixed rates, plus out-of-pocket expenses and revenue is recognized when the consulting services have been completed. However, if it is determined that a consulting engagement will be unprofitable, we recognize the loss at the time of such determination. Training revenue is recognized when the training is completed.

Warranty Expense

A warranty reserve is established based on our historical experience and an estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. While we believe that our warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due and payable could differ materially from what will actually transpire in the future. Historically, warranty expenses have not been material.

Stock-Based Compensation

On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (SFAS No. 123R), which requires us to recognize expense related to the fair value of our stock-based compensation. We adopted SFAS No. 123R using the modified prospective transition method. In accordance with the adoption of SFAS No. 123R, we chose the straight-line method for recognizing compensation expense. See Note 3 for further information regarding our stock-based compensation assumptions and expenses, including the impact of adoption on our condensed consolidated financial statements and pro forma disclosures for prior periods as if we had recorded stock-based compensation expense.

Our equity option plans are long-term retention programs that are intended to enhance our long-term shareholder value by offering opportunities to both directors and officers, as well as selected persons to participate in our growth and success and to provide incentives and encourage retention.

The 2006 Equity Incentive Plan *(formerly the 1989 Plan)*

On June 8, 2006, at the 2006 Annual Meeting of Shareholders of Captaris, Inc., our shareholders approved the Captaris, Inc. 2006 Equity Incentive Plan (the 2006 Plan), which amended and restated the Captaris, Inc. 1989 Restated Stock Option Plan (the 1989 Plan) to, among other things, expand the types of awards available for grant to include, in addition to stock options,

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CAPTARIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS continued

(unaudited)

stock appreciation rights, stock awards, restricted stock, restricted stock units and other stock or cash-based awards. The 2006 Plan authorizes the issuance of up to 12,900,000 shares of Captaris common stock, the same number authorized under the 1989 Plan. The 2006 Plan did not authorize any new additional shares. The options under the 2006 Plan are generally granted at an exercise price of the average of the high and low market value of our common stock on the date of grant, and generally vest over four years. They have a term of one to ten years from the date of grant and vest at the rate of 25% after one year and 2.0833% per month thereafter. As of September 30, 2006, there were 2,545,515 options outstanding pursuant to the 2006 Plan. In the quarter and nine months ended September 30, 2006, we granted 10,904 and 446,640 stock options and awards under the 2006 Plan, respectively.

Equity Grant Program for Non-employee Directors

Effective upon shareholder approval of the 2006 Plan, the Board of Directors, upon recommendation of the Compensation Committee, implemented the Terms of Equity Grant Program for Non-employee Directors (the NED Equity Program) under the 2006 Plan. The NED Equity Program provides for: 1) initial and annual stock option grants with a Black-Scholes or binomial (whichever method is then being used by the Company to value its stock options for financial reporting purposes) value of $10,000 on the date of grant; and 2) initial and annual restricted deferred stock unit awards (DSU Awards) with a $25,000 value based on the fair market value which we currently calculate using the average of the high and low stock price, as reported by NASDAQ, of our common stock on the date of grant. The stock options will vest in full one year after the date of grant and have a ten-year term, as long as the non-employee director remains on the Board. The DSU Awards will be automatically deferred under the Captaris, Inc. Deferred Compensation Plan for Non-employee Directors (the NED Deferred Compensation Plan) and will vest in full one year after the date of grant. The compensation expense associated with the NED Equity Program is included in our stock compensation expense.

Deferred Compensation Program

Effective upon shareholder approval of the 2006 Plan, the Board of Directors, upon recommendation of the Compensation Committee, also implemented the NED Deferred Compensation Plan, the purpose of which is to further long-term growth of the Company by allowing non-employee directors to defer receipt of certain compensation, keeping their financial interests aligned with the Company, and providing them with a long-term incentive to continue providing services. The NED Deferred Compensation Plan is administered by the Compensation Committee of the Board of Directors.

Directors who are not also employees of the Company or its affiliates are eligible to participate in the NED Deferred Compensation Plan. Non-employee directors may elect to defer receipt of 25%, 50%, 75% or 100% of any cash compensation paid to the non-employee director for his or her service on the Board of Directors or any committee of the Board of Directors. Cash compensation deferred will be credited to the non-employee director s account as of the date on which it would have been paid had it not been deferred, and will be deemed to be invested in our common stock at a value equal to the closing price of our common stock on such date. A non-employee director will be fully vested in that portion of his or her account attributable to deferred cash compensation at all times. In general, a non-employee director s vested account balance will be distributed in a lump sum as soon as administratively practicable after his or her separation from service on the Board of Directors. The compensation expense associated with the NED Deferred Compensation Plan is included in our compensation expense.

The 2000 Plan

Upon the adoption of the 2006 Plan on June 8, 2006, no further awards will be granted under the Captaris, Inc. 2000 Non-Officer Employee Stock Compensation Plan (the 2000 Plan), which resulted in a reduction in the number of options available for grant by 935,609 shares. Under the 2000 Plan, options generally were granted at the fair market value of our common stock at the date of grant and generally vest over four years. Options under the 2000 Plan have a term of ten years from the date of grant and vest at the rate of 25% after one year and 2.0833% per month thereafter. As of September 30, 2006, there were 2,469,988 options outstanding under the 2000 Plan. Prior to the adoption of the 2006 Plan, in the first six months of 2006, we granted 632,133 stock options under the 2000 Plan.

Impairment of goodwill

Our judgments regarding the existence of impairment indicators include our assessment of the impacts of legal factors; market and economic conditions; the results of our operational performance and strategic plans; competition and market share; and any potential for the sale or disposal of a significant portion of our principal operations. If we conclude that indicators of impairment exist, we then assess the fair value of goodwill. Our valuation process provides an estimate of a fair value of goodwill using a discounted cash flow model and includes many assumptions and estimates. Once the valuation is determined, we will write-down goodwill to its determined fair value, if necessary. Any write-down could have a material adverse effect on our financial condition and results of operations. We test goodwill for impairment on an annual basis in the first quarter of the year,

CAPTARIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS continued

(unaudited)

and on an interim basis in certain circumstances. We conducted our annual assessment during the first quarter of 2006 and determined our goodwill at March 31, 2006, was not impaired.

Impairment of intangibles

We periodically review our intangibles that we are more likely than not to sell or otherwise dispose of before the end of the asset s previously estimated useful life to determine if there is any impairment of these assets. We assess the impairment of these assets, or the need to accelerate amortization, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance of our intangibles. We determined that no impairment indicators occurred during the first nine months of 2006; therefore, we have not evaluated our intangible assets for impairment as of September 30, 2006. Future events could cause us to conclude that impairment indicators exist and that the assets should be reviewed to determine their fair value. We assess the assets for impairment based on the estimated future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. If the carrying amount of an asset exceeds its estimated future undiscounted cash flows, an impairment loss is recorded for the excess of the asset s carrying amount over its fair value. Fair value is generally determined based on a valuation process that provides an estimate of a fair value of these assets using a discounted cash flow model, which includes many assumptions and estimates. Once the valuation is determined, we will write-down these assets to their determined fair value, if necessary. Any write-down could have a material adverse effect on our financial condition and results of operations.

Net Income (Loss) Per Common Share

Basic net income (loss) per common share was computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period, including vested deferred stock units under the 2006 Plan. Diluted net income (loss) per common share was computed by dividing net income (loss) by the sum of (1) the basic weighted average number of shares of common stock outstanding during the period and (2) net additional shares that would have been issued, including unvested deferred stock units under the 2006 Plan, had all dilutive options been exercised less shares that would be repurchased with the proceeds from such exercises. Dilutive options are those that have an exercise price less than the average stock price during the period.

The following table sets forth the computation of basic and diluted income (loss) per common share:

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in thousands, except per share data)			
Numerator:				
Income (loss) from continuing operations	$ 1,643	$ (694)	$ 1,709	$ (4,058)
Income (loss) from discontinued operations	(16)	5	27	35
Net income (loss)	$ 1,627	$ (689)	$ 1,736	$ (4,023)
Denominator:				
Weighted average shares outstanding basic	27,859	29,056	28,131	29,077
Dilutive effect of common shares from stock options	613		486	
Weighted average shares outstanding diluted	28,472	29,056	28,617	29,077

Basic net income (loss) per common share:								
Income (loss) from continuing operations	$	0.06	$	(0.02)	$	0.06	$	(0.14)
Income (loss) from discontinued operations		(0.00)		0.00		0.00		0.00
Net income (loss)	$	0.06	$	(0.02)	$	0.06	$	(0.14)
Diluted net income (loss) per common share:								
Income (loss) from continuing operations	$	0.06	$	(0.02)	$	0.06	$	(0.14)
Income (loss) from discontinued operations		(0.00)		0.00		0.00		0.00
Net income (loss)	$	0.06	$	(0.02)	$	0.06	$	(0.14)

Due to the net loss from continuing operations in the quarter and nine months ended September 30, 2005, we excluded 182,193 and 226,706, respectively of common stock equivalents from the calculation of diluted loss per share because such securities were anti-dilutive in these periods. Employee stock options to purchase 3,692,207 shares and 4,445,060 shares in the

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CAPTARIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS continued

(unaudited)

quarters ended September 30, 2006 and 2005, respectively, and 3,871,194 and 3,734,156 in the nine months ended September 30, 2006 and 2005, respectively, were outstanding, but were not included in the computation of diluted income (loss) per share because the exercise price of the stock options was greater than the average share price of the common shares; therefore, the effect would have been anti-dilutive.

2. Segment Reporting

For segment reporting purposes, we operate in one segment. Our results of operations may fluctuate as a result of seasonal factors. In recent years, our product lines have experienced seasonality with a decline in revenue during the first quarter as compared to the prior year s fourth quarter, building gradually during the second and third quarters, and ending with the fourth quarter as our largest quarter for revenue.

Revenue by geographic region, as determined by shipping destination, was as follows:

	Quarter Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
	(in thousands)			
North America	$ 19,167	$ 16,945	$ 50,929	$ 47,679
Europe	2,179	2,232	7,626	6,783
Asia Pacific	1,734	1,333	4,167	3,967
Rest of world	1,480	1,245	4,041	3,288
Total net revenue	$ 24,560	$ 21,755	$ 66,763	$ 61,717

Revenue from the rest of world consists primarily of sales to the Middle East, Africa, India and countries in the Latin America region. Revenue from the United States was $18.2 million and $48.5 million for the quarter and nine months ended September 30, 2006, respectively, and $15.9 million and $45.2 million for the quarter and nine months ended September 30, 2005, respectively.

3. Stock-Based Compensation

On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (SFAS No. 123R), which requires us to recognize expense related to the fair value of our stock-based compensation. Prior to January 1, 2006, we accounted for stock-based compensation under the recognition and measurement provisions of Accounting Principle Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). In accordance with APB No. 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

We adopted SFAS No. 123R using the modified prospective transition method. Under this transition method, compensation cost recognized for the quarter and nine months ended September 30, 2006 includes: a) compensation cost for all stock-based compensation granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and b) compensation cost for all stock-based compensation granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R.

In accordance with the adoption of SFAS No. 123R, we chose the straight-line method for recognizing compensation expense. Previously under the disclosure-only provisions of SFAS No. 123, we used the accelerated method of expense recognition pursuant to FASB Interpretation

No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN No. 28). For all unvested options outstanding as of January 1, 2006, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For stock-based compensation granted subsequent to January 1, 2006, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

Included in our stock-based compensation are expenses relating to both our stock options and our deferred stock units. The amount of stock-based compensation expense, net of forfeitures, recognized in the third quarter and first nine months of 2006 related to stock options and deferred stock units was $235,000 and $476,000, respectively, of which $23,000 and $175,000, respectively, related to options granted prior to January 1, 2006. Total unamortized compensation expense at September 30, 2006 was $1.7 million, net of estimated forfeitures, which will be recognized over a weighted average period of two years.

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CAPTARIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS continued

(unaudited)

The following table summarizes the allocation of stock-based compensation to our expense categories for the quarter and nine month periods ended September 30, 2006 and 2005:

	Quarter Ended September 30, 2006	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(in thousands)			
Cost of revenue	$ 5	$ (5)	$ 7	$ (20)
Research and development	12	(20)	28	(72)
Selling and marketing	36	(27)	96	(108)
General and administrative	182	(7)	345	(39)
Total stock-based compensation expense (benefit)	$ 235	$ (59)	$ 476	$ (239)

In determining the fair value of stock options granted during the quarter and nine months ended September 30, 2006 and 2005, the following key assumptions were used in the Black-Scholes option pricing model:

	Quarter Ended September 30, 2006	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	4.77%	3.98%	4.87%	3.64%
Expected volatility	47.4%	49.3%	53.9%	49.9%
Expected term	5.3	4.0	5. 3	3.0

We have not declared or paid any dividends and do not currently expect to do so in the future. The risk-free interest rate used in the Black-Scholes valuation method is based on the implied yield currently available in U.S. Treasury securities at maturity with an equivalent term. Expected volatility is based on the annualized daily historical volatility plus implied volatility of our stock price, including consideration of the implied volatility and market prices of traded options for comparable entities within ou